

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
ENHANCED CORE INDEX PUBLIC REAL ESTATE EQUITY SECURITIES
(ENHANCED CORE PREES)
INTERNALLY MANAGED**

April 19, 2004

This Policy is effective immediately upon adoption and supersedes all previous Passive Public Real Estate Equity Securities (Passive PREES) - Internally Managed Policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Enhanced Core Index Public Real Estate Equity Securities (Enhanced Core PREES) - Internally Managed ("the Portfolio" or "the Fund"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Portfolio. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the Portfolio.

II. STRATEGIC OBJECTIVES

The real estate securities market is a growing and dynamic segment of the capital markets. Unique advantages of these instruments in a diversified investment program include the following:

- A. Exposure to real estate segments that are not available through the direct or private market,
- B. Liquid, efficient and cost-effective exposure to real estate generally, and
- C. The unique risk and return characteristics reflective of the favorable tax treatment for [Real Estate Investment Trusts](#) (REITs) at the corporate level and the resulting distribution of income in the form of dividends, which is especially attractive to a tax-exempt investor.
- D. REITs provide investors with a strong corporate governance structure.

Though an attractive investment, this segment of the capital markets is changing constantly as it matures. Therefore, an investment in real estate securities should be reflective of this changing environment and be sufficiently flexible to capture opportunities as they occur. The Enhanced Core PREES Index portfolio is such an opportunity.

The strategic objectives of the Fund are to accomplish the following:

- A. Provide broad exposure to solely the core property types of office, industrial, apartment and retail (shopping centers and regional malls) in a publicly traded form;
- B. Enhance the real estate investment program by accessing real estate opportunities only available in the public securities market;
- C. Provide a complement to the direct real estate investment segment in managing the asset allocation to the core property types within the overall real estate program; and
- D. Provide an investment vehicle that is managed to accomplish the following:
 - 1. Enhance the System's total return;
 - 2. Manage liquidity needs of the real estate program;
 - 3. Hedge against active (pre-retirement) liabilities;
 - 4. Provide diversification to the System's overall investment policy; and
 - 5. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The System's **Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Investment Committee delegates the responsibility for administering the Fund to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).

- B. The System's **Investment Staff's** ("the Staff") duties include, but are not limited to, the following:
1. Developing and recommending the Policy to the Investment Committee.
 2. Developing and maintaining Program Guidelines, subject to periodic reviews and updates, outlining Staff operational procedures used in implementing this Policy.
 3. Implementing and adhering to the Policy.
 4. Purchasing only securities that are outlined in the Policy.
 5. Reporting to the Investment Committee, as needed, about the performance of the Fund. The Staff shall monitor the implementation of, and compliance with, the Policy. The Staff shall report concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing to the Investment Committee.
 6. Reporting internally to senior management on this Policy. This report will be prepared monthly to include, but is not limited to, the following information:
 - a. Current market value of the portfolio; and
 - b. Performance of the portfolio versus the benchmark as reported by the Master [Custodian](#).
 7. Determining the sub-sector weights in an attempt to outperform the benchmark index in accordance with Policy Section V. Investment Approach and Parameters, Subsection B. Asset Allocation.
- C. The **General Pension Consultant** ("the General Pension Consultant") is responsible for the following:
1. Monitoring and evaluating the Fund's performance relative to the benchmark and Policy. The General Pension Consultant shall report to the Investment Committee on a quarterly basis, in accordance with its contract.

2. Constructing and maintaining the core index ("Core Index") and providing the Index to Investment Staff on a timely basis.

IV. PERFORMANCE OBJECTIVES

To meet or exceed the custom CalPERS Enhanced Core PREES Real Estate Securities Index and to contribute to the Equity Real Estate Program's out performance of the [National Council of Real Estate Investment Fiduciaries \(NCREIF\) Index](#) are the performance objectives of this Policy.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Implementation

The Public Markets Group shall construct a portfolio of real estate securities in an enhanced index manner to track the per annum return of the Core Index reflecting the target month-end weights of each sub-sector within 1.5% per annum [return deviation](#). The construction of the Portfolio shall include the transaction costs and performance associated with the asset allocation changes made in accordance with Policy Section V. Implementation, Subsection B. Asset Allocation. The return deviation amount shall be re-examined at the annual [reconstitution](#). As this market continues to develop and liquidity improves, transaction costs should decline thus improving the ability to manage tracking error. It is further recognized that standard index construction treats dividends as re-investable as of the ex-dividend date and contains no residual cash equivalents, all of which can affect the performance of a live portfolio. Furthermore, the investment return calculation of the sub-sector may vary from the internal rate of return approach used by the master custodian bank. The Public Markets Group will manage these factors to minimize their impact on tracking error.

An enhanced index approach shall be used to create a portfolio of stocks that mirror the performance of the Core Index. The weight of each security in the Portfolio shall be close to the weight of each security in the Core Index.

B. Asset Allocation

The allocation to the Portfolio will be established as part of the Annual Investment Plan process for CalPERS Real Estate Portfolio. In any event, the Enhanced Core Index Public Real Estate Equity

Securities (Enhanced Core PREES) will not violate current equity allocation ranges as set forth in the Statement of Investment Policy for Equity Real Estate.

The allocation to the sub-sectors shall be weighted according to the normalized policy weight, which is each sub-sector's market value weight in the Core Index, unless the allocation is varied at the prudent direction of the Senior Investment Officer, Real Estate.

The circumstances under which this may occur include, but are not limited to, the following:

1. More attractive valuation in the public versus the direct market for a particular property type;
2. More attractive valuation of one property type versus another;
3. To accommodate cash flow targeted to real estate awaiting direct investment; and
4. To complement exposures in the direct core real estate program.

Variances in allocation to various property types from the normalized policy weights shall be reported to the Investment Committee quarterly.

C. Trading Activity

Trading activity shall result from rebalancing each sub-sector of the Portfolio and management of [corporate actions](#) described above. Trading activity shall occur as often as necessary to maintain the security weights in line with that of the Core Index.

Trading activity may also result from the impact of corporate actions that affect the Core Index (e.g., [mergers](#) and recapitalizations). Each corporate action shall be managed on a case-by-case basis to maintain adherence to the minimization of tracking error.

Trading activity shall also result from asset allocation decisions to vary the sub-sector weights in the Portfolio from their normalized target weights. A variety of trading techniques and liquidity sources shall be utilized to obtain best execution. Crossing networks and other informationless trading techniques may be used along with

private placement investments and [acquisition](#) of stocks as part of a sale of properties to a publicly traded real estate company.

Trading costs shall be independently measured quarterly by a third-party vendor to ensure proper trading activity management.

D. Over/Under Weighting Report

An over/under weight report shall be generated monthly to display the weight of all stocks in the portfolio relative to the normalized target weight in the Core Index. Stocks shall be screened and evaluated for possible actions to decrease/increase their weight to rebalance the portfolio toward the benchmark weights. Ranges for over/under weighting of sectors will be established by the Senior Investment Officer – Real Estate. Monthly, the Program shall be reviewed to evaluate the impact of varying the sub-sector weights in the Portfolio versus the total return of the Core Index.

E. Permissible Securities

1. Securities, which are contained in the Core Index, that are headquartered in either the US or Canada.
2. The Portfolio may hold securities that are not represented in the designated benchmark. Such holdings are justified on the basis of the following:
 - a. Liquidity constraints or excessive transaction costs, e.g., those required to sell certain securities obtained from corporate actions or from past benchmark reconstitutions.
 - b. Expectation of inclusion in the benchmark at the next annual reconstitution.

F. Restrictions

1. Any security position which represents more than 5% of the outstanding shares of that security shall be liquidated as soon as it is cost effective to do so to avoid SEC reporting requirements and liquidity constraints.
2. No more than 10% of total index or portfolio holdings may consist of foreign real estate companies (exclusive of Canadian holdings).

3. Diversified securities that are defined as “Diversified” by Wilshire Associates with more than 10% in non-core property type holdings on a revenue basis will be excluded during the annual index reconstitution.
4. Diversified securities with less than 70% concentration in one of the core portfolio type holdings based on revenues will be excluded during the annual index reconstitution.

VI. BENCHMARK

The benchmark for the CalPERS Enhanced Core PREES Index (the Index) shall be NCREIF and will be measured in a manner in which the core portfolio is monitored. The Index will contain only the securities representing the four core real estate property types, as follows: office, industrial, apartment and retail (shopping centers and regional malls). The Index shall be further segregated into five sub-sectors each representing the four specified core property types (with retail broken into two sectors). The Index will be independently calculated according to the construction rules by the General Pension Consultant. The rules of construction of the Index are described below.

A. Securities Universe

The universe of real estate securities shall be screened once a year (the annual reconstitution) for those securities comprising the four core property types, as defined by the Wilshire Real Estate Securities Index. The securities shall be further segregated into the property type categories to establish five property type sub-sectors. Securities with more than 10% in non-core property type holdings on a revenue basis shall be excluded during the annual index reconstitution. Securities will be included in one of the five property type sub-sectors based on its predominant property type (i.e., at least 70% of its holdings in that property type).

B. Liquidity Test

The securities in the sub-sectors shall be screened for sufficient liquidity to support institutional investment. Since the real estate securities market is changing constantly, the determination of liquidity sufficiency shall be determined each year in coincidence with the anniversary of the Index reconstitution. That determination, to be expressed in terms of a minimum [market capitalization](#), which may vary by property type sub-sector, shall be codified in the Program Guidelines.

The factors to be considered to determine sufficient liquidity may include, but will not be limited to, the following:

1. Average daily trading volume;
2. Outstanding market capitalization;
3. Bid-ask spread relationships;
4. The number and diversity of market makers; and
5. Sufficient operating history to ensure continuance as going concerns and the professional judgment of the Senior Investment Officers for Public Markets and Real Estate.

The analysis supporting their determination of the discrete market capitalization cut-off shall be codified in the Program Guidelines. Any stock not meeting both the market capitalization and the liquidity test in that year shall be excluded from the Index. The remaining eligible securities shall be weighted according to market capitalization.

C. Asset Allocation

The allocation to the five sub-sectors to create the normalized weighted index shall be determined by the relative market value of the combined securities that make up each sub-sector.

D. Reconstitution

The Portfolio shall be reconstituted annually as of June 30 for potential additions and deletions to the index. The Index shall be adjusted for material corporate actions and changes in outstanding shares. Corporate actions will include Initial Public Offerings and private market acquisitions. Treatment of corporate actions shall consider the same factors used to develop the CalPERS Internally Managed Domestic Equity Index (Policy, Guidelines, and Procedures, Section VI. Investment Approach and Parameters, Subsection E. Corporate Actions and are incorporated herein by reference.

VII. GENERAL

Investors, managers, consultants, partners, members, or other participants selected by the System shall make all calculations and computations on a market value basis as recorded by the System's Custodian.

VIII. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the System's Master Glossary of Terms.